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Message Text

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ACTION ARA-10

INFO OCT-01 ISO-00 CIAE-00 DODE-00 PM-04 H-01 INR-07 L-03
NSAE-00 NSC-05 PA-01 PRS-01 SP-02 SS-15 USIA-06
AID-05 COME-00 EB-08 FRB-03 TRSE-00 XMB-02 OPIC-03
LAB-04 SIL-01 OMB-01 /083 W
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FM AMEMBASSY SANTIAGO
TO SECSTATE WASHDC 3749

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C O R R E C T E D C O P Y (ADDING ALOW, AFSP, AFIN TO TAG LINE)

E. O. 11652: N/A
TAGS: EFIN, ECON, CI, EAGR, ALOW, AFSP, AFIN
SUBJECT: MINISTER OF FINANCE ANNOUNCES MEASURES TO BRING DOWN INFLATION AND STIMULATE PRODUCTION

SUMMARY: GOC ANNOUNCED MARCH 4 A PACKAGE OF POLICIES TO REDUCE INFLATION AND STIMUALTE PRODUCTION. MOST UNEXPECTED WAS THE DECISION TO REVALUE THE PESO BY 10 PERCENT. OTHER MEASURES INCLUDE A REDUCTION IN INCOME, SOCIAL SECURITY AND TRANSFER TAXES AND IN BANK RESERVE REQUIREMENTS, NEW CREDITS TO THE DEVELOPMENT BANKS AND TO EXPORTERS, AND MEASURES DESIGNED TO FACILITATE FOREIGN INVESTMENT INFLOWS. REVALUATION OF THE PESO WAS JUSTIFIED BY SATISFACTORY DEVELOPMENT OF EXPORTS AND BOP. STIMULATIVE EFFECTS OF TAX REDUCTIONS AND LIBERALIZED CREDIT ARE EXPECTED TO MORE THAN OFFSET DEPRESEIVE IMPACT OF A MORE EXPENSIVE PESO. TIME WILL TELL. END SUMMARY.

2. ON EVENING OF MARCH 4 FINANCE MINISTER SERGIO DE CASTRO ANNOUNCED A POLICY PACKAGE DESIGNED TO BRING INFLATION UNDER CONTROL SIMULTANEOUSLY WITH HIGHER LEVEL OF DOMESTIC ECONOMIC ACTIVITY.
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THE MOST UNEXPECTED ELEMENT IN HIS WELL-PRESENTED PACKAGE WAS A 10 PERCENT PESO REVALUATION, FROM 19.75 PESOS TO 17.77 PESOS TO THE DOLLAR. MOST OBSERVERS CONSIDERED THE PESO ALREADY OVERVALUED. DE CASTRO DEEMED A HIGHER PESO VALUE JUSTIFIED BY CONTINUED RAPID EXPANSION OF CHILE'S NONTRADITIONAL EXPORTS, AND BY CHILE'S FAVORABLE 1977 BOP PROSPECTS. THE RECENT SURGE IN COPPER PRICES, THOUGH UNNOTED, ALSO IMPROVES THOSE PROSPECTS.

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DE CASTRO CLAIMED THAT IN REAL TERMS THE PESO WILL HAVE ONLY SLIGHTLY GREATER PARITY THAN WHAT IT AVERAGED OVER THE SECOND HALF OF 1976, AND WILL BE 20 PERCENT CHEAPER THAN THE PESO OF OCTOBER 1973 JUST FOLLOWING THE MILITARY COUP.

3. THE GOC HAS DECIDED TO MODIFY THE POLICY INSTITUTED IN JULY 1976 OF DAILY PESO DEVALUATIONS BASED ON THE PREVIOUS MONTH'S CPI INCREASE. DE CASTRO ANNOUNCED THAT THE PESO WOULD BE DEVALUED BY FOUR PERCENT BETWEEN MARCH 5 AND APRIL 4 (AS CONTRASTED WITH FEBRUARY'S 5.8 PERCENT RATE OF CIP INCREASE), AND BY THREE PERCENT BETWEEN APRIL 5 AND MAY 4. EXCHANGE RATE ADJUSTMENTS THEREAFTER WILL REVERT TO THE SYSTEM INSTITUTED IN JULY.

4. OFFSETTING THE CREDIT TIGHTENING EFFECTS OF PESO REVALUATION -- MORE MONEY FLOWS OUT FOR INPORTS AND LESS FLOWS IN BY WAY OF EXPORTS -- IS A MODEST REDUCTION IN RESERVE REQUIREMENTS ON BANK SIGHT DEPOSITS, FROM 83 PERCENT TO 75 PERCENT. DEVELOPMENT CORPORATION (CORFO) CREDITS OF US$60 MILLION TO IMPORTERS OF CAPITAL GOODS, DIRECT CENTRAL BANK CREDITS OF US$45 MILLION TO THE DEVELOPMENT BANKS AND MORE LIBERAL TERMS FOR EXPORT CREDITS WILL, OVER TIME, ALSO HELP TO MAKE CREDIT CONDITIONS SOMEWHAT EASIER.

5. TO STIMULATE DEMAND, THE GOC HAS DECIDED TO ACCELERATE SCHEDULED REDUCTION IF DIRECT TAXES. PERSONAL AND CORPORATE INCOME TAX REDUCTIONS, WHICH WERE TO BE EFFECTED IN 1978, WILL, INSTEAD, BE MADE IN 1977. THE TRANSFER TAX ON REAL PROPERTY TRANSACTIONS IS BEING CUT BY HALF. A REDUCTION IN EMPLOYEE SOCIAL SECURITY TAXES WILL HELP TO REDUCE PRODUCER COSTS THEREBY ENHANCING LIMITED OFFICIAL USE

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THEIR ABILITY TO COMPETE WITH FOREIGN PRODUCERS.

6. DE CASTRO ANNOUNCED THAT THE FOREIGN INVESTMENT LAW WOULD BE AMENDED SO AS TO ELIMINATE BUREAUCRATIC DISCRETION IN AWARDING TAX OR OTHER CONCESSIONS. REDUCING SCOPE FOR NEGOTIATIONS IS EXPECTED TO SPEED UP THE SIGNING OF FOREIGN INVESTMENT CONTRACTS AND THE INITIATION OF FOREIGN INVESTOR PROJECTS.

7. COMMENT: OUR JUDGMENT IS THAT THIS ALONE WILL NOT DO IT. DE CASTRO CLAIME THAT THIS PACKAGE WOULD INCREASE DEMAND ENOUGHT TO ACCELERATE ECONOMIC RECOVERY. HE WARNED BUSINESSMEN THAT THE GOC WOULD NOT COME TO THEIR RESCUE IF THEY CONTINUE TO JACK UP THEIR PRICES IN THE FACE OF CHEAPER FOREIGN EXCHANGE AND IMPORTS MADE POSSILBE BY PESO REVALUATION.

8. COMMENT: DISSATISFACTION WITH THE ECONOMIC TEAM AMONG THE MILITARY AND BUSINESS AND BANKING COMMUNITY HAS INCREASED IN THE WAKE OF RECENT SCANDALS IN LOCAL FINANCIAL INSTITUTIONS. MANY WERE ALREADY UNHAPPY WITH THE RELATIVELY SLOW PROGRESS OF

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ECONOMIC RECOVERY. THE DE CASTRO PACKAGE, WHICH WAS COMPLETELY
UNEXPECTED, IS A BOLD STROKE TO REFOCUS THE ATTENTION OF PUBLIC
AND MILITARY ON POSITIVE ASPECTS OF PROGRAM AND THEREBY WIN TIME.

9. THE ECONOMIC TEAM IS OBVIOUSLY PERSUADED, AND APPARENTLY HAS
PERSUADED PRESIDENT PINOCHET, THAT REAL ECONOMIC DEVELOPMENT
WILL NOT GET UNDERWAY UNTIL INFLATION IS BROUGHT UNDER CONTROL.
HENCE, THE UNORTHODOX REVALUATION OF THE PESO AT A TIME OF STILL
HIGH UNEMPLOYMENT AND LOW CAPACITY UTILIZATION. A CHEAPENING OF
IMPORTS WILL BRING STRONGER PRESSURES ON SOME PRODUCERS TO
HOLD THE LINE ON PRICES. INFLATION WILL COME DOWN, THOUGH AT
SOME COST TO LOCAL PRODUCTION. IT SHOULD, HOPEFULLY, CEASE TO
BE THE OVERRIDING PREOCCUPATION OF THE ECONOMIC TEAM.

10. THE DE CASTRO TEAM BELIEVES THAT THE BOP EFFECTS WILL BE MODERATE,

PRESUMABLY MOST PROFIT MARGINS ON NON-TRADITIONAL EXPORTS
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ARE HIGH ENOUGH TO ABSORB THE PESO REVALUATION. CONTINUED HIGH,
THOUGH DECLINING, INTEREST RATES ARE EXPECTED TO AVERT LARGE
CAPITAL REFLOWS. SUBSTANTIAL INTERNATIONAL RESERVES WILL ENABLE
CHILE TO FINANCE THE EXPECTED SURGE IN IMPORTS. CREDITS SHOULD
HELP SUSTAIN PRESENT LEVELS OF EXPORTS.

11. MORE PROBLEMATIC ARE THE LONGER TERM EFFECTS OF THESE
MEASURES. AN UNDERVALUED PESO ENABLE CHILE TO EXPAND EXPORTS
RAPIDLY DURING A PERIOD OF BOP DEFICIT. A CONTINUING REAL
REVALUATION OF THE PESO, HOWEVER, WILL TEND TO DAMPEN INVESTOR
INTEREST IN EXPORTS. PRODUCTION FOR THE DOMESTIC MARKET IS,
BY THE SAME TOKEN, MADE RELATIVELY LESS PROFITABLE IN THE FACE
OF HIGHER INITIAL CAPITAL OUTLAY AND CHEAPER COMPETITIVE IMPORTS.
THUS, THIS POLICY PACKAGE WOULD HAVE A MORE STIMULATIVE IMPACT
ON CONSUMER GOODS IMPORTS THAN ON INVESTMENT AND DOMESTIC OUTPUT.
IF THIS HAPPENS, THE ECONOMIC TEAM MIGHT WELL BE IN TROUBLE AGAIN
FOR HAVING PROMISED MORE THAN THEY COULD DELIVER.
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